

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
ARCADIA INDUSTRIES, INC.,)
DeWAIN R. AND EMILIA BUTLER,)
AND ELMER O. AND PHYLLIS M.)
RODEFFER)

Appearances:

For Appellants: Robert L. **Whitmire**
Attorney at Law

For Respondent: David M. Hinman
Counsel

O P I N I O N

These appeals are made pursuant to sections 25667 and 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Arcadia Industries, Inc., **DeWain** R. and Emilia Butler, and Elmer O. and Phyllis M. Rodeffer against proposed assessments of additional franchise and personal income tax in the amounts and for the years as follows:

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<u>Appellants</u>	<u>Taxable Years</u>	<u>Income Years Ended</u>	<u>Proposed Assessments</u>
Arcadia Industries, Inc.		4-30-66 4-30-67	\$ 742.44 87.36
DeWain R. and Emilia Butler	1965		5,905.43
Elmer O. and -Phyllis M. Rodeffer	1965		6,719.43

Arcadia Industries, Inc.', is a California corporation all of whose stock is owned by appellants DeWain Butler and Elmer Rodeffer. In 1960 the corporation entered into an agreement with the City of Arcadia concerning the purchase of 24 lots of unimproved real property fronting on Peck Road in Arcadia. The agreement provided for the immediate sale of four lots to the corporation and also gave it certain option rights to acquire the adjacent 20 lots from the city. As of April 30, 1965, the corporation had purchased eight lots in all, and had also expended \$43,576.38 for the construction of certain off-site improvements required by the agreement. On May 4, 1965, the city deeded the remaining 16 lots to Butler and Rodeffer, as individuals, for a purchase price of ten percent more than the remaining balance under the agreement, plus accrued interest.

Respondent investigated the transactions described above and determined that under the 1960 agreement the corporation owned a right to purchase the 16 lots at a 'bargain price, that the corporation had transferred that right to its shareholders in 1965, and that, to the extent of the bargain element of the 1965 acquisition from the city, the corporation had made a taxable distribution of property to its shareholders. Respondent also determined that the corporation was not entitled to depreciate its investment in the off-site improvements and that, for basis purposes, the cost of these improvements must be allocated among all 24 lots covered by the 1960 agreement. The appellants have disputed each of the adjustments resulting from these determinations, as more fully explained below.

I. Did Rodeffer and Butler receive a taxable distribution of property from their corporation?

Revenue and Taxation Code section 17321 provides as follows:

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Except as otherwise provided in this part, a distribution of property (as defined in Section 17383(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in Section 17323.

Subdivision (a) of section 17383 defines "property" as "money, securities, and any other property."

Section 17323 provides, in relevant part:

In the case of a distribution to which Section 17321 applies --

(a) That portion of the distribution which is a dividend (as defined in Section 17381) shall be included in gross income.

(b) That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(c) (1) . . . that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

Section 17381 defines a "dividend" as follows:

For purposes of this part, the term "dividend" means any distribution of property made by a corporation to its shareholders --

(a) Out of its earnings and profits accumulated after February 28, 1913; or

(b) Out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

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Except as otherwise provided in this part, **every** distribution is made out of earnings and profits to the extent thereof, and from the **most** recently accumulated earnings and **profits**. To the extent that any distribution is, under any **provision** of this chapter, treated as a distribution of property to which Sections 17321 to 17324, inclusive, apply; **such** distribution shall be treated as a distribution of property for purposes of this **section**.

The four sections quoted above are based on, respectively, **sections** 301(a), 317, **301(c)**, and 316(a) of the Internal Revenue Code of 1954. In a case where a corporation distributed to its shareholders rights to purchase property from it at a bargain **price**, the U.S. Supreme Court held that **when** a corporation sells **corporate** property to its shareholders for less than its fair market value, thus diminishing the corporation's net **worth**, it is engaging in a "distribution of property" constituting a dividend, unless some **specific statutory** exception **applies**. (Commissioner v. Gordon, 391 U.S. 83 [20 L. Ed. 2d 448] (1968); see also Rev. Rul. 70-521, 1970-2 Cum. Bull. 72.) The appellants do not **contest** the validity of this legal principle, but they argue that it is not applicable in this case **because** the **corporate** appellant had no enforceable "right" to acquire the land in question, and thus **had** no property right **that** it **could** have distributed to its shareholders.

There is no question or dispute that the corporation originally possessed a right to buy the land under its option contract with the city. Appellants contend, however, that the corporation's right of **acquisition** had terminated as of **April** 1965, **because** of the corporation's breach of several express terms of the **contract**. Specifically, the corporation had failed to **commence construction** on a lot **acquired** in December 1963, and had failed to make a **payment of \$4,573.12** due to the city on December 28, 1964, as consideration for the option. It is clear that the corporation did breach the agreement in these respects, and that the city could rightfully have **refused** to make any further sales to the corporation under the agreement. The record contains ample **evidence**, however, that the city elected to waive the **corporation's** breaches and to **treat** the agreement as still in force.

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The first indication of the city's attitude came on December 31, 1964, when, despite the defaults referred to above, the city sold an additional lot (lot #14) to the corporation for the price specified in the agreement. The California courts have held that where, as here, one party accepts the other's further performance under a contract, with knowledge of the other's breach, a waiver of the breach has occurred and the first party has thereby elected to affirm the contract. (Boone v. Templeman, 158 Cal. 290 [110 P. 947] (1910); Kern Sunset Oil Co. v. Good Roads Oil Co., 214 Cal. 435 [6 P.2d 71] (1931); Leiter v. Eltinge, 246 Cal. App. 2d 306 [54 Cal. Rptr. 703] (1966).) Moreover, documents contemporaneous to the sale reveal that the city's sale of the 16 lots to Butler and Rodeffer in May of 1965 was actually negotiated between the city and corporation. Such negotiations between the parties to a contract also indicate a waiver of prior breaches of the contract by one of the parties. (Spiegelman v. Metropolitan Life Ins. Co., 21 Cal. App. 2d 299 [68 P.2d 1006] (1937)).

On the record before us, we are persuaded that the corporation still had the right to buy the 16 lots from the city in 1965. Certainly, the city thought so at that time, and although the sale to the shareholders differed in several respects from the terms of the 1960 agreement, we do not agree with the appellants that it was the result of an entirely new agreement between the city and the shareholders. The best evidence of this is that on April 20, 1965, the Arcadia City Council authorized the sale to the corporation for a price based on the consideration stipulated in the original contract, plus ten percent of that amount and "interest to May 1, 1965." The inclusion of "interest" is particularly revealing because the amount to be paid (\$5,984.31) appears to have been equal to the amount due the city under the 1960 agreement as consideration for keeping the option open until May 1, 1965.^{1/}

^{1/} When the shareholders paid this "interest," therefore, the city apparently recouped the option consideration of \$4,573.12 that the corporation had failed to pay on December 28, 1964.

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Although we are not in possession of all of the **facts** surrounding this transaction, we have concluded that the sale was made pursuant to the 1960 contract even though that agreement did not contemplate a sale exactly on the terms negotiated in 1965. The city and the corporation simply modified the terms of the original contract, as they were entitled to do at any time. (See Civ. Code, § 1698.) We find, therefore, that the corporation made a distribution of property to its shareholders that is subject to the provisions of section 17321 et seq.

II. Has respondent correctly computed the amount of the distribution?

Revenue and Taxation Code section 17322 provides that, for purposes of sections 17321-17324, the amount of a distribution is the amount of money received, plus the fair market value of the other property received. Subdivision (c) of section 17322 stipulates that fair market value shall be determined as of 'the date of the distribution. Respondent's position is that the fair market value of the right ~~to~~ purchase the 16 lots was \$312,060, computed as follows:

Fair market value of the land	\$384,000 (16 x \$24,000)
Purchase price of the land	- 71,940
Value of the right to purchase	<u>\$312,060</u>

Respondent supports its valuation of the land on three grounds. First, on June 8, 1965, one month after the shareholders acquired title to the land, the corporate appellant sold two of the eight lots it had acquired from the city to an unrelated third party, Mr. Geddes, for \$24,000 a lot. These **two lots** were identical in size and shape to the 16 lots in question, and they were located adjacent to the 16 lots on the **same street** in Arcadia. Second, a 1967 appraisal

2/ Respondent has conceded on brief that the proposed assessments erred in valuing the distribution at more than \$312,060. The assessments will, therefore, be adjusted to reflect this concession.

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done for a corporation related to the appellants appraised three other lots in the same tract at \$24,000 a piece. Third, the employee of the Los Angeles County Assessor's Office who appraised the property for tax purposes in 1969 and 1970 stated that he believed a value of \$24,000 a lot in 1965 was reasonable.

The appellants contend that the 16 lots were worth no more than the price paid by the shareholders. They argue that this price was arrived at by arm's length bargaining with the **city**, and that there is no evidence that the city believed it was selling the land for only a fraction of its real value. We believe, however, that this "bargaining" was pervaded by the 1960 agreement between the corporation and the city, and that the purchase price agreed upon was governed more by that agreement than by the parties' estimates of the real value of the land. Moreover, regardless of what the city officials believed that value to be, the evidence shows rather clearly that the lots were, in fact, worth a great deal more than Rodeffer and Butler paid for them. Specifically, we believe respondent's valuation of \$24,000 a lot is reasonable and amply supported by the record. Although the appellants have argued that the Geddes **sale does not accurately reflect the** property's fair market value **because** he was impelled to make the purchase for tax **reasons,**^{3/} there is no evidence that Mr. Geddes was thereby willing to pay a price some five times greater than Butler and Rodeffer paid for very similar property. We are also not convinced that there were any significant differences in grading and fill requirements that would make the Geddes lots more valuable than those in question.

III. Has respondent correctly calculated the amount of the distribution taxable as a dividend?

In accordance with section 17323, quoted in Part I above, respondent treated the distribution to the shareholders **as** partly a dividend, partly a return of capital, and partly a

^{3/} It appears that some of Mr. Geddes' property had been **taken** in condemnation proceedings and that his purchase of two lots from the corporation was for the purpose of reinvesting the proceeds in qualified replacement property, in order to avoid recognition of the gain realized from the condemnation. (See Rev. & Tax. Code, §§ 18082-18084.)

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capital gain. The appellants have advanced several arguments in support of their contention that respondent erred in computing the corporate appellant's earnings and profits, and thereby erred in computing the portion of the distribution taxable as a dividend to the shareholders.

First, appellants argue that the distribution took place in the corporation's taxable year ended April 30, 1965, when the corporation had a deficit in both current and accumulated earnings and profits. Respondent's position is that the distribution took place after April 30, 1965, and thus fell in the taxable year ended April 30, 1966, when the corporation had earnings and profits of **\$67,715.11**. We believe respondent is correct. A memorandum from the city manager to the Arcadia City Council on May 4, 1965, shows that as of that date the sale was still to be made to the corporation. Later that day, when the council met, Butler and **Rodeffer** were substituted as grantees of the deeds to the property. This suggests that the distribution to the shareholders occurred no earlier than May 4, and appellants have offered no evidence tending to show that the distribution occurred prior to May 1, **1965**.

Second, appellants contend that respondent incorrectly **computed** the corporation's earnings and profits for the year ended April 30, 1966, because the auditor increased **the** corporation's reported gain on the Geddes sale. In computing its **gain**, the corporation included in the basis of each lot one-eighth of the depreciated cost of certain off-site improvements the corporation had been required to construct under the 1960 agreement. The corporation allocated the total adjusted basis of these improvements to the eight lots (including the two sold to Geddes) that it had acquired prior to the city's sale of the remaining 16 lots to the shareholders. Respondent determined that the improvements benefitted all 24 lots equally, and that the basis of each of the lots sold to Geddes should therefore include only one twenty-fourth of the cost of the improvements. Respondent and the appellants agree that resolution of this issue depends upon whether **the** corporation had a right to purchase the 16 lots and distributed that right to **its shareholders**. Since we have already held that this was the case, it follows that respondent correctly allocated the cost of the off-site improvements to all 24 lots covered by the original 1960 agreement.

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Finally, the appellants object to respondent's determination that the corporation is not entitled to **depreciate** the cost of the off-site improvements referred to **above.**^{4/} This determination was based on respondent's conclusion that the corporation had no depreciable interest in these facilities, which **consisted** of a sewage pumping station, a water main, engineering for sewers, clearing and grading, and other improvements. Respondent reached this conclusion after learning that the facilities were dedicated to the city, which has borne all costs of repairing, maintaining, and replacing them.

In a case where the taxpayers, who were developers of multiple-housing projects, constructed sidewalks, curbs, paved streets, sewers, and water mains in conjunction with their projects, and then turned over to local government units all the maintenance responsibilities for these facilities, the Tax Court held that the taxpayers had no depreciable interest in the sidewalks, etc. (Algernon Blair, Inc., 29 T.C. 1205, 1220-1222 (1958); see also F. M. Hubbell Son & Co. v. Rurnet, 51 F.2d 644 (8th Cir. 1931).) Since the facilities had been dedicated to public use and had become part of local street systems, the court felt that they were being used primarily in the public's, not the taxpayers', business, and that the taxpayers thus did not have the special pecuniary interest in the facilities that is necessary to support a depreciation deduction. We believe that holding is controlling in this case. The off-site improvements were dedicated to public use, were maintained by the city, and were not used primarily in the corporation's business. The case of D. Loveman & Son Export Corp., 34 T.C. 776 (1960), *aff'd*, 296 F.2d 732 (6th Cir. 1961), *cert. denied*, 369 U.S. 860 [8 L. Ed. 2d 18] (1962), relied on by appellants is distinguishable. In that case the taxpayer was allowed to depreciate its share of the cost of paving a dead-end road adjoining its warehouse. The local government had refused to pave the road and did not maintain it, and although it was **open** to public use, the dead-end road was obviously not used primarily in the public business but rather in the **businesses** of those persons who owned property adjoining it.

On the basis of the above, we can find no error in respondent's computation of the corporation's earnings and profits or of its tax liability for the years in question.

4/ Respondent's determination on this issue **apparently gave** rise to the deficiencies assessed against the corporation, as well as causing an upward revision of the corporation's earnings and profits for the year of the distribution to its shareholders.

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There-fore, respondent's determination of the amount of the distribution taxable as a dividend to the shareholders will be sustained, as will the deficiencies against the corporation. The deficiencies assessed against the individual appellants will be revised in accordance with respondent's concession regarding the amount of the distribution.

O R D E R

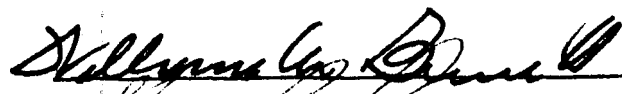
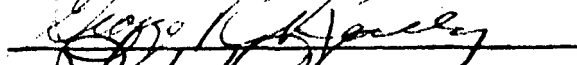

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to sections 25667 and 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Arcadia Industries, Inc., DeWain R. and Emilia Butler, and Elmer O. and Phyllis M. Rodeffer against proposed assessments of additional franchise and personal income tax in the amounts and for the years as follows:

<u>Appellants</u>	<u>Taxable Years</u>	<u>Income Years Ended</u>	<u>Proposed Assessments</u>
Arcadia Industries, Inc.		4-30-66 4-30-67	\$ 742.44 87.36
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be and the same is hereby modified in accordance with respondent's concession regarding the amount of the distribution. In all other respects, respondent's action is sustained.

Done at Sacramento, California, this 6th day of April, 1977, by the State Board of Equalization.

, Chairman
, Member
, Member
_____, Member
_____, Member

ATTEST: , Executive Secretary